THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 270 **October 1995**

The Great Dollar Hoax Exposed

> **"Fateful illusions had been conjured up by misconceptions of the monetary order. The chief reason for the financial confusion of the late 1920s, as in similar eras of the past, was the credit inflation. Combined with stable prices, it generated a sense of security and an overestimation of the expansionary potential. This misled a dynamic society into recklessly speculative ventures on an unprecedented scale."**
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> **The Twilight of Gold**
> **Melchior Palyi, 1972**

After a brief hiatus, currency instability has returned to threaten the global financial markets. The dollar bulls, so confident just a few short weeks ago that the greenback was poised for further gains, instead have seen it suffer an abrupt reversal – precisely as we predicted in our last letter.

Europe's politicians, meanwhile, have seen their foolish dreams of currency union battered by yet another ERM crisis. Once again, nervous investors have fled en masse from the soft currencies, in particular the British pound, the Italian lira and the Spanish peseta, to the safe havens of the Deutsche mark and the Swiss franc.

The triggers for renewed turmoil were hardly world-shaking. Disappointment with Japan's new fiscal plan, combined with unexpectedly bad U.S. trade figures, sufficed to produce a dollar sell off. In Europe, critical comments by Germany's finance minister on Italy's hopes of qualifying for monetary union were enough to rattle speculators.

It hardly should come as a surprise to hear that America's trade deficit is out of control, or that Japan's reflation efforts are too little and too late, or that Italy's public finances are a complete disaster. The violence of the reaction in the markets simply indicates how vulnerable they have become, owing to the extreme speculative distortions.

One striking feature of recent events is the utter failure of the central banks to control them. Barely four weeks after the massive interventions of August, their hard-won dollar rally is crumbling. Even interest rate moves no longer create the desired effect. Increasingly, rate cuts in the hard currencies are seen as proof of their superior strength.

We would say governments and central banks are losing their ability to fight the economic fundamentals underlying the various currencies. The recent interventions, intended as a display of determination, look more and more like evidence of collective impotence. They easily could backfire, causing a dramatic loss of confidence in the markets.

In this letter, we look at the external imbalances imperiling the dollar. The trade figures are merely part of the story. U.S. capital outflows present an equal threat. Combined, these outflows and the U.S. current account deficit now are running at more than $400 billion annualized. The rest of the world simply cannot finance this staggering sum.

We also take this opportunity to explain some basic premises behind our analytical work. In particular, we hope to explain our classical views of credit, inflation and the role of monetary policy, and offer some thoughts on the interplay between the economic fundamentals – which we have always stressed – and short-term speculative forces. Increasingly, it seems to us that only by taking both into account can one understand and explain the dangerous imbalances now threatening the world's financial markets.

THE BEST OF ALL POSSIBLE WORLDS?

While the world economy has been faltering, the financial markets continue to revel in bullish sentiment. By experience, investors have learned to view economic sluggishness, combined with falling inflation and the prospect of easier money, as the best of all possible worlds for them. As interest rate cuts so far have failed to restimulate the economies, more seem in store, boosting bond and stock markets.

Yet the markets surely have lost steam. What is the matter? To find the answers to such questions, our general approach is to examine the different sources of funds flowing into the financial markets with the question in mind: How much of it is sheer speculative froth? In 1991-93, the prolonged bull run of the U.S. bond market was driven mainly by soaring demand from two sources: banks, which increased their bond portfolios in those three years by no less than $285 billion; and yield-curve speculators, who financed their huge bond purchases with borrowed, cheap short-term money.

Both groups unloaded in 1994. The banks did so because they needed funds to support their lending binge to the private sector, and the speculators did so because the Fed's successive interest rate hikes effectively undercut their lucrative yield-curve playing. Since we saw no alternative buying sources, we remained bearish on U.S. bonds.

Nevertheless, the U.S. bond market managed another bull run this year. But who were the big buyers this time? We can identify two: first, foreign central banks and investors; second, the same familiar crowd of speculators. But given the flattened yield curve, the latter chose to shift much of their activity to the derivatives markets. Where before they used debt-leverage to exploit the gap between short and long rates, now they leverage through futures trading, as reflected in one of the largest swings in history in U.S. bond futures from a net short to a net long position.

But in hindsight, it is clear that soaring foreign buying was the true catalyst for the bond rally. In the first half of 1995, foreign purchases of U.S. government securities totalled a staggering $98 billion, or $196 billion annualized. Purchases by foreign central banks alone soared from $11.3 billion in the first quarter to $26.5 billion in the second, compared to just $39 billion in the whole of 1994. All told, purchases of U.S. assets by foreign central banks amounted to a record $60 billion, or $120 billion annualized.

In its desperate attempts to devalue the yen, the Bank of Japan has drastically stepped up its dollar purchases. But there is every reason to suspect that it now camouflages its interventions by channelling them through private financial institutions. As these institutions also make the related U.S. bond purchases under their own names, official flows are effectively dressed up as private flows.

We have gone into some detail about the buying sources behind this year's U.S. bond rally because they reveal that the conventional explanations, which stress low and falling inflation, are utter shenanigans. The truth is that Wall Street and most U.S. investors stayed on the sidelines as the bull run unfolded earlier this year. Actually, most Wall Street firms were aggressively bearish.

The hard reality is that foreign central banks, acting out of sheer desperation, have played a decisive role in supporting U.S. bonds – not only with their direct bond purchases, but also indirectly with their currency interventions, which prevented a dollar rout that would have played havoc with the U.S. financial markets. To be sure, these interventions now play an important role, one that investors must take into account. But we shouldn't deceive ourselves that recent dollar movements reflect regular market forces.

Overall, the United States attracted in the first half of 1995 a record $209 billion inflow of capital, after $291.4 billion in all of 1994. This begs the question: Why has the dollar continued to weaken, despite such huge inflows? One obvious reason is the progressive deterioration of the U.S. current account. More important, however, is the virtual explosion in capital outflows – a trend that started in 1992, after the Fed had thrown open its money spigots to revive the U.S. economy.

During the first half of this year, U.S. capital outflows totalled a staggering $150 billion, compared to $42.7 billion in the first half of last year. The chief cause of this dramatic swing was a massive reversal in

Global Capital Market Trends

Equities
Selected Markets, % Change

Country (September 26)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	0.5%	17.0%	5.7%	-1.7%	16.7%
Canada	-1.5%	7.3%	3.7%	-4.0%	13.2%
France	-6.3%	-3.5%	-4.5%	-10.0%	5.5%
Germany	-1.0%	5.8%	8.2%	-3.8%	16.6%
Hong Kong	5.5%	17.0%	-0.3%	-2.2%	37.5%
Japan	0.9%	2.0%	-8.0%	-11.1%	23.7%
Mexico	-2.1%	1.5%	-14.4%	-15.1%	66.6%
Spain	-3.3%	10.2%	7.1%	-4.0%	18.7%
U.K.	-0.0%	14.9%	17.1%	-1.3%	19.7%
U.S.	3.8%	26.6%	25.8%	-0.9%	30.5%

Ten-Year Bond Yields
Selected Markets, Basis Point Change

Country (September 26)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo. H	Vs. 12-Mo. Lo
Australia	8.68	-49	-131	-155	-204	15
Canada	7.88	-18	-126	-110	-180	20
France	7.43	14	-84	-71	-100	19
Germany	6.55	-14	-107	-104	-120	12
Japan	2.82	-49	-175	-184	-211	22
Spain	10.91	3	-92	-24	-165	36
U.K.	7.97	-6	-75	-93	-95	28
U.S.	6.26	-9	-156	-130	-177	24

Exchange Rates
Versus U.S. Dollar, % Change

Country (September 26)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	1.34	0.6%	-3.6%	1.2%	-4.0%	5.3%
Canada	1.35	-0.1%	4.0%	0.2%	-0.7%	5.5%
France	4.95	2.6%	7.3%	6.7%	-4.1%	9.3%
Germany	1.44	2.3%	7.3%	7.5%	-6.2%	9.7%
Japan	100.96	-4.4%	-1.4%	-2.2%	-25.2%	3.4%
Spain	123.81	1.0%	5.9%	3.7%	-4.8%	7.7%
U.K.	1.57	1.0%	0.1%	-0.3%	-4.5%	2.1%

banking transactions with the Euromarkets. Funding their rapid domestic credit expansion in 1994 largely with Eurodeposits, U.S. banks attracted a record $114 billion from abroad, giving corresponding support to the dollar. This year, by contrast, outflows of roughly equal size were generated by their lending to foreigners – $65 billion in the first half.

We suspect this recent sharp rise in U.S. bank lending to foreigners was largely related to short-term currency hedging, based on dollar negative expectations. In general, forward currency purchases are covered by borrowing dollars from U.S. banks in the spot market. Remarkably, the resulting short-term outflows fully offset portfolio capital inflows during in this period.

LOOSE MONEY AND ITS PROXIES

The unquestionable root cause of the dollar's long-term downtrend is permanent, excessive monetary looseness. This is the root cause behind the chronic, huge U.S. current-account deficit, behind the surge in U.S. capital outflows, and behind the seemingly endless boom in the U.S. financial markets. All of these, in the last analysis, are proxies of loose money.

Normally, such monetary looseness would meet its nemesis in a collapsing currency, forcing the central bank into a savage monetary tightening. But in the case of the United States, no such external constraint comes into play since, in the place of the Fed, foreign central banks – particularly the BoJ – are readily taking care of the dollar.

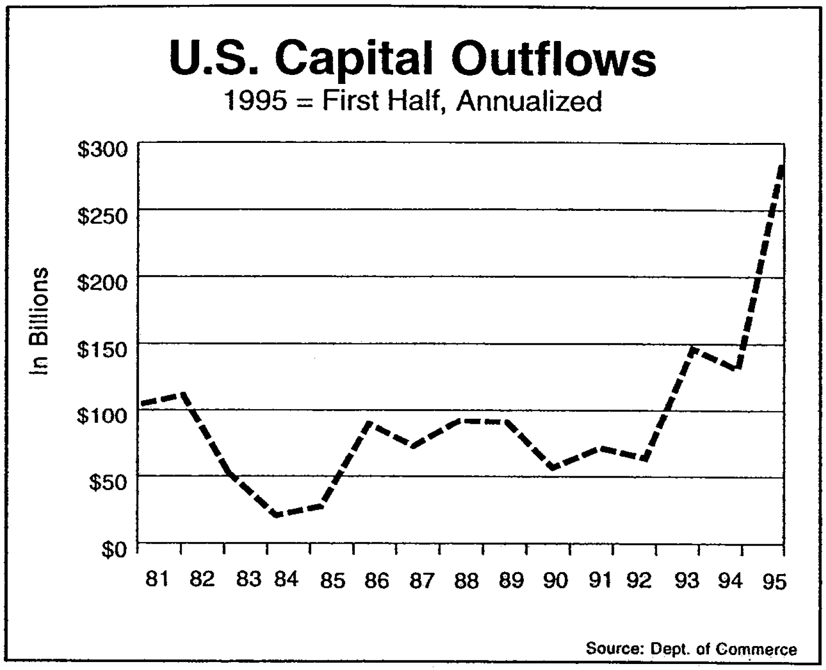
We realize our opinion about U.S. monetary looseness clashes with the diametrically opposite views of the American monetarists, who complain that the Fed remains highly restrictive and is in danger of triggering a recession. Their favorite gauges are the persistent weaknesses in narrow money (M1) and the monetary base. Most Wall Street economists, on the other hand, seem to regard the Fed's stance as just right for the economy and the markets.

At this point the reader may be asking: Isn't it an idle question whether or not U.S. monetary policy is tight or loose, as long as the economy is growing and inflation remains low? Well, the point is that prolonged periods of loose money with low economic growth and low inflation rates tend to be the times of speculative bubbles.

Where are the imbalances in the United States? Consider, as one example, this fact: During the first half of 1995, U.S. nominal GDP grew at an annual rate of $114 billion. Non-financial debt, meanwhile, grew at an annual rate of $373 billion – creating a record high debt-to-GDP growth ratio of 327%. In our last letter, we

mentioned that this ratio has averaged 200% so far in the 1990s. That's up from a steady 130% or so for most of the postwar period until the late 1970s.

In the same vein, we note that in the United States an equally monstrous imbalance has developed between the huge financial flows into the credit and stock markets, and the meager supply of current domestic savings. It used to be conventional wisdom in economics that the equilibrium or "natural" rate of interest is, in the worlds of economist Knut Wicksell, the rate "at which capital flows and the supply of savings exactly agree." In the United States, the flow of loanable and investable funds has in recent years ranged between $1 billion and $1.3 billion a year – four to five times larger than the ongoing supply of domestic savings.



FUNDAMENTALS VERSUS SPECULATION

Belatedly, we recently came across the book, The Alchemy of Finance, by George Soros, the noted investor who is, by the way, a long-time subscriber to our letter. It seems he worries just as much as we do that great booms have a habit of ending in great busts. But, he adds: "Reading the record, it is striking how many calamities that I anticipated did not in fact materialize." He goes on to ask himself why and how disaster has been averted so often, and draws the tentative conclusion that there is something in the behavior of markets that tends to prevent busts.

We, too, have repeatedly posed the same question to ourselves. Looking at the world economy, we see unprecedented budget and balance-of-payments deficits, and chronic overconsumption and underinvestment in many countries. To us, this indicates an inherent and unprecedented shortage of savings in the world. Yet booming financial markets around the globe seem to reflect the best of all possible worlds, feasting on an overabundant supply of capital.

Soros's central thesis, which he calls his theory of reflexivity, is that supply and demand in the markets are not fixed, but rather are prone to be changed by the expectations and speculative actions of market participants. These changes usually are adaptive, and thus tend to drive both the economy and the markets away from their long-run equilibrium. This has become all the more true as short-term speculation has gained unprecedented importance in the financial and currency markets. From this, Soros draws the conclusion that investors must develop a conscious, integrated analysis of both fundamental and speculative forces. In effect, they must operate according to a two-way feedback mechanism – rather than simply relying on conventional equilibrium theory, or mindlessly following the latest speculative trend.

Soros also stresses the frequent differences between objective reality and the prevailing, flawed perceptions that determine or reinforce a given bias or trend in a market. But as any trend extends, a speculation-driven market becomes increasingly vulnerable as it moves more and more against the fundamentals.

While insisting that market valuations always are distorted, Soros distinguishes between near-term equilibrium conditions, in which classical theory applies, and extreme disequilibrium, in which analysis along the lines of classical economics is totally inappropriate.

Reading this, we thought a lot about our own approach, as evidenced in these letters. Clearly, we are not trend followers. We analyze the course of events strictly on the basis of classical equilibrium theory. Yet at the

same time we realize the importance of trend-following speculation. In line with the famous slogan that "the trend is your friend," most advisors and investors simply follow the prevailing bias in the markets. To be sure, simple trend following has its merits. As Keynes pointed out, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

Nevertheless, we think that even a trend follower should keep a critical eye on the fundamentals "as they are," and not as they are falsely perceived – if only to retain some sense of the underlying risks. We believe there are many market participants who "play" the trends, but who still want to understand what's really going on, in order to know whether a given market trend is sound and therefore sustainable. In this sense we distinguish between mechanical trend followers and thinking market participants. We address ourselves to the latter.

Is the worldwide financial boom we have been witnessing these past few years sound and sustainable? For us, that is the all-important question, and one that every investor ought to explore. Put differently, are the bullish trends in the financial markets in accordance with or in conflict with the underlying fundamentals?

The trouble is that most economists today don't have the faintest idea what the relevant and decisive fundamentals are. Monetarists such as Milton Friedman offer pure number crunching without a trace of a theoretical concept. Their wisdom begins and ends with asserting that the rate of money growth is all that matters and that central banks have full control of the money supply, if only they choose to exercise it. In their eyes, all inflationary evils come from too much money and nothing else. Credit is an aggregate they ignore because their statistical research allegedly has disproved any connection between credit and economic growth and inflation.

On this point, Soros writes: "The theory of reflexivity leads me to believe that his (Milton Friedman's) theory is wrong. I would expect that the two sides (credit and money) influence each other in a reflexive fashion, and his dream of controlling the money supply is impractical. I lack sufficient expertise to take him on directly, but I can point to empirical evidence that shows that the money supply always fails to behave in accordance with the regulators' wishes."

Actually, this exclusive concentration on the current supply of money is an American invention. Before Milton Friedman, European economists traditionally focused on credit as the decisive monetary aggregate. In the last analysis, they had a credit theory, not a money theory.

The key argument of the monetarists in favor of money is that in comparison to credit it is better linked to spending. But two circumstances speak in favor of credit: First, bank deposit growth – the main component of broad money – is governed by the growth of bank credit and investments. Second, credit statistics give us valuable insights into the use of borrowed money.

THE THREE FACES OF INFLATION

The centerpiece of classical equilibrium theory was the balance between financial flows, mainly credit and savings. In the eyes of the classical economists, any flows of funds in excess of current savings were, by definition, of an inflationary nature, regardless of what happened to the prices of goods and services. In contrast to their contemporary counterparts, the old economists understood very well that, depending on how inflationary funds are spent, inflation can take three different forms: rising prices of goods and services; rising asset prices; or a rising trade deficit.

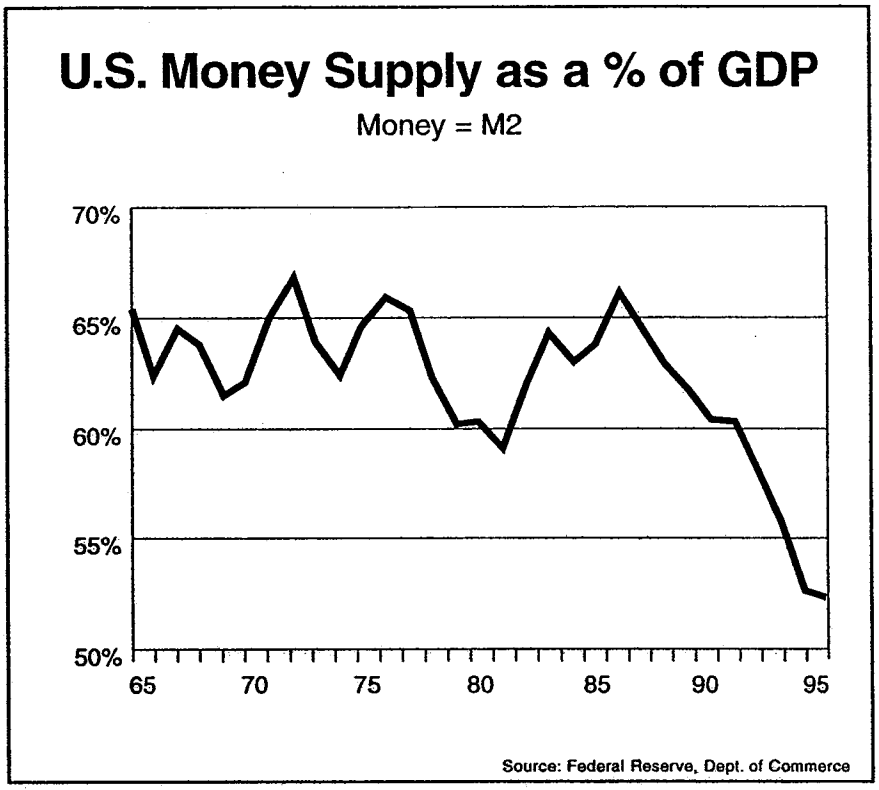
Today, for the most part, inflation is narrowly and primitively defined as an increase in the price indexes for goods and services. Correspondingly, low inflation rates in these indexes are supposed to imply the complete absence of any excesses and imbalances, both in the real economy and in the financial system. Classical economists, by contrast, distinguished strictly between the causes and the effects or symptoms of inflation. While inflation can take different forms, it always has one and the same cause: money and credit flows in excess of savings.

Looking for inflation, the classical economists focused on these flows in excess of savings. They also had a clear concept of the specific sources of such inflationary flows: lending by banks or nonbanks, and dishoarding.

The important differences among these three sources lie in the fact that only bank lending involves money creation. The flows from the other two sources leave the existing money stock unchanged. Instead, they raise money velocity. As to the term "dishoarding," it applies to cases where money holders draw on their existing money balances to buy goods or securities – presently a main source of the U.S. financial bull market. Such "flights from cash" tend to play a great role in all inflations.

Our analytical work always has been guided by this equilibrium concept of the classical economists. It is the root of our view that the world financial system is out of kilter as never before. Financial flows have decoupled completely from the meager supply of savings. Just as paradoxically, world money growth is at its lowest ebb in the entire postwar period.

Altogether, it's a most confusing picture. But in order to understand the future implications of this phenomenon, it is necessary to understand its root cause. The basic, central reason for this strange contrast between financial excess and economic sluggishness, in our view, is the fact that our debt-ridden economies are becoming steadily less responsive to monetary stimulation. As a result, more and more easing is required to generate growth. But this same steady diet of loose money chronically overstimulates the financial markets.



The odd result: Financial markets keep booming, precisely because the economies have lost their former dynamism. At the same time, banks, brokers and other financial intermediaries have constructed an unprecedented global infrastructure to foster financial speculation.

This raises another question: How is such rampant speculation possible at a time of record-low money growth. Looking primarily at the United States, we see three reasons:

- As already mentioned, credit creation largely has shifted away from the banks to nonbank lenders and the capital markets, where it involves no money growth.
- U.S. banks have funded much of the growth in their loans and investments with managed liabilities, such as Eurodollar borrowings, that are not counted as part of the money supply.
- Much, if not most, of the cash flowing into the booming financial markets comes from the total stock of money in existence. This recycling process, or in technical terms, the explosion in transaction velocity, also involves no change in the money supply.

For these and other reasons, the money supply figures are obsolete. What truly counts is credit. Borrowed money – whatever its origin – most certainly is spent on something.

THE ENDLESS STRUGGLE

It surely is a useful concept to see behind the movements of the markets a constant struggle between fundamental and speculative forces. Speculation causes permanent deviations from the equilibrium. Yet, look-

ing at the performance of different markets, we have the impression that the fundamentals exert a stronger influence in some than in others.

Applying his "reflexivity" concept specifically to the stock market, Mr. Soros expresses the opinion that "stock prices are somehow connected to fundamentals." Here we must totally disagree. Of all the financial markets, the stock market is the one most prone to random speculation.

Famed economist Joseph Schumpeter dwelled on the same question and gave three reasons for this eccentricity of stock markets. Firstly, they tend to be narrow markets, at least compared to credit and currency markets. Comparatively small amounts of money can go a long way towards moving prices up or down. Secondly, there is much more scope for irrational fancy and downright foolish hopes than in ordinary business pursuits. Thirdly, mere stock trading absorbs no liquidity. As Schumpeter put it: "Transactions (in the stock market) are relatively small; there is no time element in stock transactions, because there is no economic process to go through. It is therefore true that stock speculation does not absorb money or capital or credit in the sense usually implied by this phrase. New issues, of course, do 'absorb funds,' but only to release them, unless the proceeds be applied to the repayment of bank credit."

As a matter of fact, the U.S. stock market presently is creating credit and money as the merger mania and other corporate share purchase programs buy such stocks largely with borrowed money.

U.S. Stock Purchases and Sales

In Billions of Dollars, Annual Rates

Sector	1994 QI	1994 QII	1994 QIII	1994 QIV	1995 QI	1995 QII
Private Households, Net	$69.2	$63.4	-$33.9	-$143.1	-$91.3	-$47.4
Direct Sales	-$110.1	-$10.1	-$139.7	-$127.8	-$131.7	-$188.7
Stock Mutual Fund Purchases	$179.3	$73.5	$105.8	-$15.3	$40.4	$141.3
Corporate Net Purchases	$9.6	$2.0	$50.0	$118.0	$68.4	$73.2

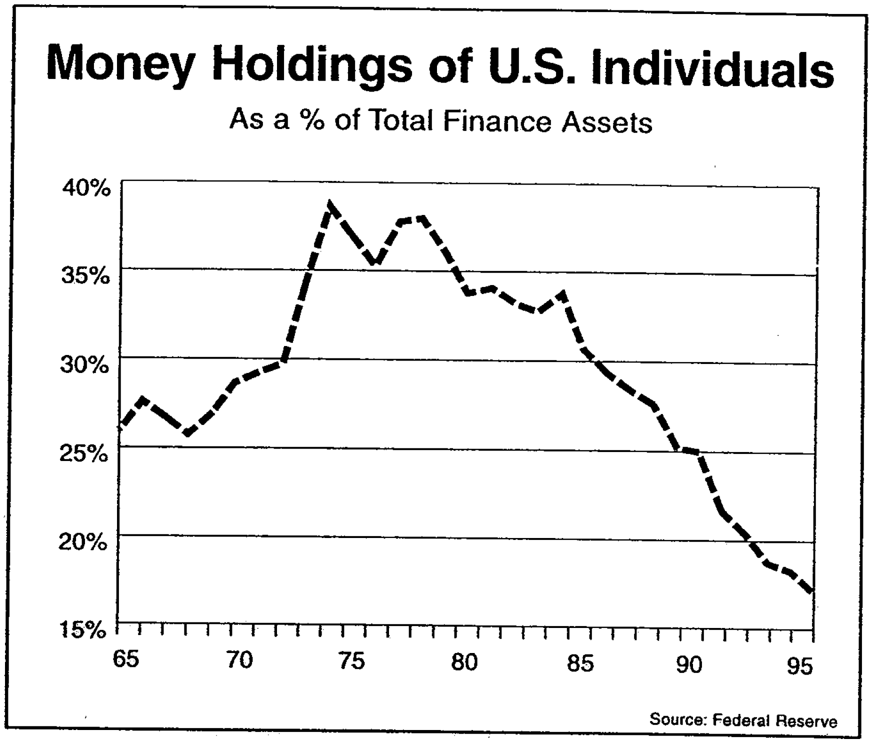
Source: Federal Reserve

By various traditional measures, the U.S. stock market – and many others around the world – are absurdly overvalued. One of the most often cited reasons for the bull run of the last few years is the stampede of individual investors through stock mutual funds into equities, which continues unabated. During the first seven months of 1995, these flows totalled more than $65 billion. That puts them at nearly the same pace as in 1994, which saw inflows of $119 billion, and 1995, when inflows totalled $130 billion.

But this explanation doesn't fully tally with the facts. Since the middle of last year, private U.S. households increasingly have been net sellers of stocks. What they have bought through mutual funds has been more than offset by sales of directly owned equities, as shown in the table above. In truth, the biggest net buyers of U.S. stocks now are corporations themselves. Here, too, the trend shifted in the middle of last year. Since then, corporate buybacks have flooded the markets with money – much of it borrowed – far in excess of new issues. Also, heavy trading in stock index futures – and the associated arbitrage-related purchases that take place in the cash markets – may have played an even greater role in sustaining the present bull market than generally is realized, just as the flood of broker loans in the 1920s provided the necessary leverage to inflate the stock-market bubble of that era.

Here is an example of how perception and reality can grossly diverge. The popular image is that the bull run in U.S. stocks has been driven by the rush into stock mutual funds, as individual investors have succumbed

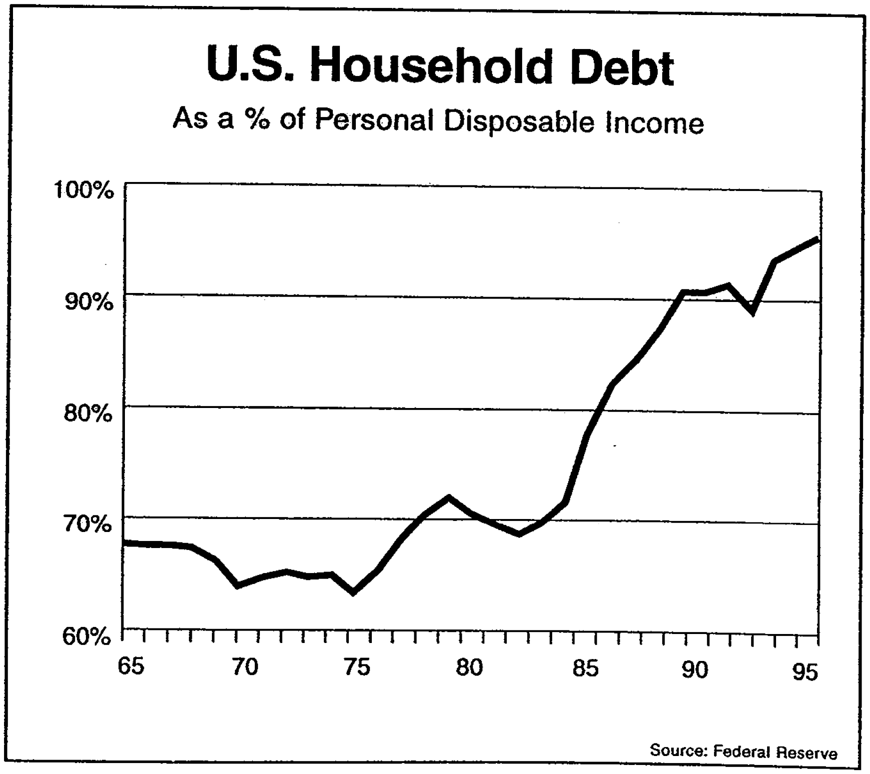
to the argument that stocks have returned an average 10% per annum over the past seven decades, and therefore can be counted on to yield at least that much for the indefinite future.



Considering that U.S. households are sitting on a colossal horde of almost $5 trillion in bank deposits, it is easy to draw the conclusion that there is still a lot of money that can be switched into stocks, lifting the Dow Jones to the 7,000 level, or even higher. Some Wall Street analysts actually make this argument. Clearly, once you adopt the entire U.S. money stock as the measure of potential future stock purchases, the sky is the limit.

Asked to explain the strange coincidence of both heavy buying and heavy selling by private households, our old friend Al Sindlinger tells us that older investors are selling, while the younger ones are doing the buying, often with borrowed money. We had expected something like this to be the case.

Considering this buying structure behind the U.S. stock market boom, we would say that it is a clear example of asset-price inflation, or a financial bubble, overwhelmingly fueled by money from sources other than new savings. In the case of corporations, stock purchases are fueled largely by borrowed money, while individual investors pay for their stock purchases largely by running down their money balances, hoping for capital gains.



Logic and experience say that all bubbles must burst some day, because they depend on abnormal flows that are prone to sudden reversals. But while they last, they can generate tremendous economic distortions and financial imbalances. In Japan's case, these imbalances included grossly excessive fixed investment. In the U.S. case, the primary result has been chronic overconsumption. But common to all bubbles is a gross overextension of balance sheets. In the United States, this can be seen clearly in the steady deterioration of household finances, as shown in the accompanying charts.

In this light, any market forecast essentially is quite random. What we can say, however, is that the present boom depends utterly on continuous U.S. monetary looseness. We see two chief risks on the horizon. One would

be a dollar crisis that would force the Fed to tighten its monetary reigns more seriously. The other is simply a retrenchment by the American consumer, which seems unavoidable over time, considering their overextended balance sheets.

THE CURRENCY GAME

Comparing the relative weight of fundamentals and speculation in various markets, we like the currency markets best. Any major distortions or speculative bubbles are fairly easy to identify. The biggest profits have been made with little or no risk when speculators have operated in compliance with the fundamentals of a given currency. Another reason for this agreeable propensity of the currency markets is their vastness, particularly the markets for the major currencies, such as the dollar.

To repeat a remark from Mr. Soros: All markets are biased. In general, the currency markets have been biased in favor of a strong dollar. For years, we have been a rather lone bearish voice in this regard. The bulls place their faith in the theory of purchasing power parity, which suggests the dollar is drastically undervalued against both the mark and the yen. We, on the other hand, always have held that a U.S. current account deficit of $150 billion a year, if not higher, simply is too big to be accommodated by private capital flows from the rest of the world. Over the past few years, soaring U.S. capital outflows have added considerably to this problem. As a deficit country, the United States can only re-export capital that it has borrowed from abroad. But there is no automatic mechanism – save a declining currency – to ensure that these flows are matched.

Even the central banks, with their permanent, immense dollar purchases, have failed to counteract these horrible dollar fundamentals. Remarkably, the dollar has been weak despite booming U.S. financial markets, which tend to attract foreign investors. Any declines in those markets surely will make it even worse for the dollar.

Speaking of flawed perceptions, the Japanese yen is just as interesting as the dollar. Repeatedly, big speculators have burnt their fingers by betting on a falling yen. Their chief error has been their belief that a feeble Japanese economy, associated with a financial crisis and extremely low interest rates, implies a declining currency.

What the speculators have missed in this respect is the necessary distinction between deficit and surplus countries. No doubt, the dollar would collapse under such conditions, as the vast army of America's foreign creditors took flight. But in the case of a creditor, surplus country, such as Japan, these conditions enforce large repatriations of funds from abroad, pushing the yen upward.

EUROCURRENCY BUNGLING

The year 1999 is fast approaching, the year when Europe's as-yet unnamed common currency is supposed to make its appearance. Before that happens, though, two hurdles must be crossed. First, a qualified majority of all 15 member countries of the European Union must formally decide which countries are eligible for participation. If, as seems inevitable, the majority fails to meet the required criteria, then those countries that are eligible theoretically would be obliged to go forward on their own. But in the end, this also will depend on obtaining the consent of a qualified majority, which will have the official power to say whether or not a country has met the required criteria.

To qualify for the common currency, a country has to meet a number of convergence criteria, as stipulated in the Maastricht Treaty. These concern exchange-rate stability, inflation rates, fiscal deficits, long-term interest rates and aggregate levels of public indebtedness.

Clearly, these criteria are not going to be met by most candidates. At present, only Germany and Luxembourg fulfill all conditions. At best, bending the rules a bit, France, the Netherlands and Austria may yet make it on time. Together, that's five out of 15 countries, or about 40% of the EU's population.

If Europe's politicians were only half as stability-minded as they pretend to be, they would give up on this project. Most countries are so far from some or all of the entry targets that realistically they have no chance of ever reaching them. But the essence of modern Europe and its political class is endless horse-

trading for advantages and money. Predictably, the politicians will do everything possible to avoid an outcome that would damage their ambitions.

So, sooner or later, there will be talk of the need for a more flexible approach. If something is off-target, just get the responsible government to commit on paper to mend it later. If the politicians could get away with this, no doubt they unscrupulously would do so. But fortunately, Germany's Constitutional Court has erected some barriers against arbitrary action. Two years ago, the court ruled that a breaking of the convergence criteria would conflict with the German constitution.

But why would the inflation-wary German public accept the risk that their currency will be debauched? One obvious reason is that they have never been asked for their opinion. Another is that the German political parties and the German banking establishment all play the "European" card, while the Bundesbank has silenced itself by declaring the decision to move to a common currency is a political question, outside its jurisdiction.

Frankly speaking, we have viewed the prospect of monetary union with alarm and dismay right from the start. If recent developments are any indication, many investors are coming to share our concerns. Certainly, the first sign of flight into the Swiss franc is a good barometer of the collapse of confidence in the EMU project.

Typically, the arguments in favor of EMU switch to and fro, from claims that a currency union will bring important economic benefits, to idealistic hopes that the political benefits will outweigh any economic disadvantages. But what is economically bad cannot be politically good.

Why is a common currency for Europe so bad? In sum, because the politicians have made too many false promises. The weak-currency countries expect large-scale financial transfers, which will help them restructure their economies. The German public, in turn, is beguiled by government propaganda that promises the common currency will be "precisely as hard as the Deutsche Mark" – a kind of Euro D-mark.

The regular line of reasoning is that the soundness of the Eurocurrency will be guaranteed by the fact that the new European Central Bank will be closely modeled on the Bundesbank, that is, it will enjoy complete independence from EU governments, and will have a contractual obligation to give priority to maintaining price stability.

Putting it mildly, we think that no responsible government can honestly promise that a Euromark will be as stable as the German mark. The reference to the Bundesbank as the model for the European Central Bank is simply eye wash. Apparently, the Eurocurrency optimists don't even realize that the Bundesbank was created in the exact image of the U.S. Federal Reserve System, which nevertheless has a very different inflation-fighting record.

In legal terms, both central banks are equally independent from governments and parliaments. In addition, both are protected by elaborate institutional safeguards designed to guarantee the personal independence of each member who sits on their key decision-making councils. These include long tenures of office and restrictive provisions on any removals. In this respect, Fed governors actually enjoy the higher level of protection – they serve 14-year terms, compared to only seven years for their Bundesbank counterparts. In the case of the Eurobank, terms will be even shorter – a mere five years.

STABILITY CULTURE

But the truly crucial difference between Fed policy and Bundesbank policy is that the German public, the German media and most German economists have altogether a very low tolerance of inflation, coupled with a ready acceptance of the monetary discipline needed to curb it. This contrasts strikingly with the situation in America, where both the public and the politicians have a pathological fear of recession and a corresponding bias in favor of low interest rates. The inevitable result is higher inflation.

This simple comparison between the Bundesbank and the Federal Reserve gives the clear lie to the assertion that good legal and institutional arrangements, by themselves, provide any guarantee of currency stability. Ultimately, the policy of a central bank rests fully on national public support for its goals and methods.

However, public support for a central bank is by no means only a matter of mentality. No less important is the public's actual behavior, that is, its propensity to save and to borrow. It is incomparably easier to maintain low inflation in a high-savings, low-consumption country, such as Germany or Japan, than in a low-savings, high-consumption country like the United States.

Assessing the causes of Germany's superior price stability, we give the Bundesbank credit for perhaps 50% of it. The other half goes to a public that is extremely conservative in financial matters, like the Americans of 30 or 40 years ago. Some call it a "stability culture." Nobody in Germany mortgages his or her house to spend the money on consumption, except perhaps as a matter of dire emergency. It simply is not done, even if Bundesbank policy temporarily is too loose. In the United States and Britain, on the other hand, borrowing has become a way of life, all the more avidly indulged in when the Fed is in an easing mode.

Taking these and many other complicating factors into account, we are increasingly nauseated by the persistent declarations of German politicians and leading bankers that the Eurocurrency will be every bit as strong as the DM. Of the special conditions that have underpinned Germany's outstanding stability performance since the end of World War II, not a single one will be present on the broader European scene.

There is no such thing as "European" public opinion on matters of inflation. Quite a few of the governors of the future European Central Bank will come from countries where the German anti-inflation consensus has no footing, as can be seen from their current problems and disputes.

Considering, moreover, the tremendous differences that exist in economic structures as well as in the productivity and wage levels of the various EU countries, and the fact that fiscal, employment and social policies remain fully under national control, one can only gasp at the audacity of a policy that would – at one stroke – equalize interest-rate levels and structures across such a heterogenous mix of countries. The very idea is madness.

Hitherto, changes in exchange rates have been one of the essential ways in which the relative strengths and weaknesses of the European countries could be expressed and adjusted. With that mechanism gone, there will be strong pressure on the Eurobank to accommodate the tremendous differences in economic structures and employment through a looser monetary policy, especially since it is implicitly stipulated in the Maastricht Treaty that every EU citizen should be able to find a job in his or her region or country.

HEADING FOR A EURODISASTER

For us, it has always been a foregone conclusion that the Maastricht Treaty will end on the rocks. It is clear to us that the politicians and the bankers who advocate it have never really thought it through. The final revolt, we think, will come when investors in the low-interest, hard-currency countries rudely awaken to the fact that the common currency will inflict on them immediate, heavy wealth losses. This absurd effect will result from the circumstances of the transition, specifically, from the fact that the vast bulk of outstanding financial claims and liabilities will be converted at existing exchange rates and interest rates.

Concretely: The German investor will end up in the new currency with the same low yields of 6-7% that he earned in the hard DM, while the Italian investor will end up with bonds yielding in the new currency the same high 11-12% he earned in the weak lira. As the common currency will abolish currency risk, it will also do away with national interest-rate differentials, which are largely related to currency risk. Bond prices will adjust to a new, common level. In the process, investors in low-yielding hard currencies will suffer huge capital losses, while investors in the high-yielding soft currencies will reap huge capital gains.

This prospect, of course, is an irresistible lure to speculation in the bonds of the weak-currency countries. But as we have seen so vividly over the past three years, this speculative attraction also leaves the weak countries vulnerable to massive capital flight whenever their chances of obtaining admission to the common-currency club appear to diminish. Thus, ironically, does EMU, which was designed to eliminate currency instability in Europe, actually serve to aggravate and perpetuate it.

Any knowledgeable person must realize that monetary union is a reckless economic and political gamble. Actually, it's worse than a gamble because it hasn't a chance of functioning as smoothly as its advocates promise. With all the financial and economic problems that it is sure to create, it will do irreparable economic and political damage. It is folly, pure and simple.

It is difficult to escape the conclusion that those in responsible positions, the politicians, bankers and economists who have fostered this travesty upon Europe, have distinguished themselves in self-deception, if not outright intellectual dishonesty.

CONCLUSIONS

More important than the reasons for the latest dollar sell-off is the message it sends: The greenback's previous, month-long rally was nothing more than a speculative binge, heavily reinforced by the central banks. Nevertheless, there are still enormous long positions outstanding, as many players continue to bet on a longer-term dollar revival. The threat that these holdings sooner or later could be sold will keep the markets jittery and exchange rates volatile.

The rush into the DM wasn't just a move out of the dollar, but a move also out of the high-yielding soft currencies of Europe. Their bond markets were hardest hit. Though we don't believe a common European currency will ever come into being, the threatened approach of one certainly will continue to vex European currency markets and in particular European bond markets. Such being the case, it appears prudent to us to stay away from all longer-term European bonds, even those of Germany and the other hard-currency countries. Extreme uncertainty, rather than fundamentals, will drive these markets for years to come.

The current merger frenzy may well continue to drive U.S. stock prices higher. Credit to finance acquisitions readily is available at interest rates more attractive than they've been for years. Still, it's a hazardous roller-coaster ride. Any number of events – disappointing earnings, a major bond-market reversal, or even a politically driven default by the U.S. Treasury – could pop the stock-market bubble. Extreme caution is warranted.

The big question now is whether the dollar's sudden, sharp setback is just a correction before the next upward move begins, or whether the dollar will spiral back down towards new lows. We feel sure it will be the latter. But the speed of the dollar's decline will depend very much on the central banks and their interventions.

THE RICHEBÄCHER LETTER

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